No. 12,664

IN THE

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER, and LILLIE S. WEGEFORTH,
Respondents.

PETITION FOR REHEARING.

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Table of Authorities Cited

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To the Honorable William Denman, Chief Judge, and to the Honorable Associate Judges of the United States Court of Appeals for the Ninth Circuit:

This petition for a rehearing is filed because we are convinced it can be conclusively shown that the decision of the Tax Court should be affirmed.[1]

The decision of this Court results in taxing to the stockholders of the Spreckels Company distributions of capital. These distributions were unquestionably distribu-

[1]Twelve judges of the Tax Court concurred in the majority opinion.

tions of capital in an *accounting* sense. They were unquestionably distributions of capital in a *legal* sense. And they were *in fact* distributions of capital. Almost all the stockholders of the Spreckels Company sustained very large losses unusable for tax purposes upon the final liquidation of the company on December 31, 1948, in spite of the fact that their cost basis had been reduced by the distributions here involved and those occurring in subsequent years which were treated as distributions of capital.[2] The decision in this case, which will of course be controlling in subsequent years, will further increase the very large losses realized upon final liquidation by another $5,000,000 as a result of taxing as dividend income what in fact was but a partial return of capital.

It is a general principle of corporation law that dividends paid in the face of an operating deficit are regarded as paid from capital. The opinion of this Court recognizes the existence of this legal principle but states that it is of no importance here. But this principle is the recognition of a basic concept of *universal* application. It is a basic concept of the terms "earned surplus," "undivided profits" and "earnings or profits" that a corporation can have no earned surplus, or undivided

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[2]The Spreckels Company had been in the process of liquidation for some years prior to the years 1939-1940 here involved. It had sold various capital assets and distributed the proceeds, and its stockholders had paid taxes on all these proceeds until its earned surplus, including the inherited earned surplus of Oceanic, was exhausted. Thereafter the stockholders paid tax on all distributions to the extent of the current earnings of the corporation. It was only such distributions as exceeded both the current earnings and the earned surplus which were treated as distributions of capital.

profits, or earnings or profits unless its assets (after providing for liabilities) exceed its capital. It was the recognition of this basic concept which caused the Supreme Court to decide in *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, 218, that

> "* * * it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus,' that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.' "

Of course a corporation with an operating deficit, that is to say with an impaired capital, can have annual income. No one denies that Oceanic had annual income while it was restoring its impaired capital and that this income was subject to income tax and was in fact taxed, but Oceanic did not have an earned surplus, or undivided profits, or earnings or profits.

It may be that a corporation with an impaired capital may also be said to have undivided profits, or earnings or profits, *of the current year.* Congress was of this opinion when it added, in 1936, the second portion of the definition of a dividend which included within the definition a "distribution made * * * out of the earnings or profits of the taxable year." But certainly a corporation cannot be said to have an *accumulation* of earnings or profits unless it has undivided profits as defined by the Supreme Court, or an earned surplus, that is to say unless an impaired capital has been restored. That is why

the Supreme Court stated in *Commissioner v. Phipps,* 336 U. S. 410, 418, that a corporation can have "no accumulated earnings or profits until its actual deficit from prior losses is erased."

This Court has held that Congress intended to ignore this basic principle when it defined a dividend as a distribution from "earnings or profits accumulated after February 28, 1913." This Court has held that Congress intended to tax as income to the recipient a distribution which under well-understood principles of corporation law is universally regarded as a distribution from capital. This Court has also held that Congress had the power to tax such distributions of capital as income within the meaning of the Sixteenth Amendment. We respectfully submit that this Court erred in failing to recognize that distributions made by a corporation with no undistributed current earnings of the taxable year and with an impaired capital are distributions of capital and beyond the power of Congress to tax as income. Our position in this regard is set forth on pages 28-30 of our brief and need not be repeated here.

But we assert that the constitutional question is not reached in this case because we respectfully submit that this Court erred in holding that Congress, when it defined a dividend as a distribution from "earnings or profits accumulated after February 28, 1913," intended to ignore the general principle of corporation law that dividends paid in the face of an operating deficit are regarded as paid from capital. It must be remembered that the reason which impelled Congress to so define a dividend was to eliminate

from the income tax distributions from pre-1913 earnings, which Congress regarded as similar to the stockholder's capital investment in the corporation because his equity in these earnings had been acquired prior to the imposition of the income tax. Is it conceivable that Congress, in adding a phrase to the statute for the purpose of protecting from tax a distribution from *earnings* which it thought should be treated as capital, should have simultaneously intended by the same phrase to subject to tax a distribution from what was unquestionably *capital?* The answer seems obvious. But it is unnecessary to speculate since Congress has specifically recognized the basic principle that unless a corporation has earnings or profits, or an earned surplus, a corporate distribution constitutes a return of capital. This basic principle is clearly expressed in section 201(d) of the Act of 1924, the pertinent portion of which reads as follows:

> "(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits,* then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 204, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *" (Italics added.)

Thus any distribution which is not out of earnings or profits must be applied against and reduce the basis of the stock and if it exceeds the basis the excess is to be taxed as a gain on the sale of property. Here is a clear

recognition that earnings or profits are essential to the declaration of a taxable dividend. If there are no earnings or profits at the time of a corporate distribution then the distribution is not a dividend but is applied against the basis of the stock. The reason the distribution is applied against the basis of the stock is that the *source* of the dividend, there being no earnings or profits, must of necessity be capital. Thus the Congressional Committee Reports of both the House and the Senate in referring to this section of the Revenue Act of 1924 state:

> "This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* or increase in value of property accrued prior to March 1, 1913 (such as distributions out of unrealized appreciation in value of property or out of depreciation or depletion reserves) *constitute a return of capital* to the stockholder and are taxable to him only if, as, and to the extent that they exceed the basis of his stock." (Italics added.)

Section 201(d) of the 1924 Act was repeated in identically the same form in the Act of 1926 and as section 115(d) in the Acts of 1928, 1932 and 1934. Thus during the period 1924 to 1935, both inclusive, covering five major Revenue Acts, the existence of earnings or profits, in other words, an earned surplus, was an essential prerequisite to the declaration of a taxable dividend. These Revenue Acts, therefore, conform to the general principle of corporation law that dividends paid in the face of an operating deficit are distributions of capital. It is clear beyond argument that during this period at least a distribution made by a

corporation with no earnings or profits is not a dividend and cannot be taxed as income to the recipient. And yet the Commissioner states in his reply brief (page 10) that "There never has been a time when such a distribution (by Oceanic) would not have been taxed as a dividend to the distributees."

This statement is obviously erroneous. But the Commissioner has been forced to contend that a distribution made by Oceanic under any of the Revenue Acts of 1924, 1926, 1928, 1932 and 1934 would have been taxable to the recipients as a dividend. The Commissioner was faced with the necessity of choosing either of two arguments—(1) he could contend that the words defining a dividend in the five major Revenue Acts during the years 1924 to 1935, both inclusive, had changed their meaning in later acts although Congress repeated the identical words without change, or (2) he could contend that under these five major acts the existence of earnings or profits, in other words an earned surplus, was *not* an essential prerequisite to the declaration of a taxable dividend. He chose the second alternative. The Commissioner has thus recognized that the meaning of the statutory definition of a dividend under these Acts is the crux of this case.

The Commissioner's argument on this point is set forth on pages 5 to 10 of his reply brief. It is based upon a comparison of section 201(c) of the 1921 Act with the corresponding section 201(d) of the 1924 Act. The 1921 Act provided that if a distribution was not out of "(1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated * * * prior to

March 1, 1913'' then it would be applied against and reduce the basis of the stock.[3] The 1924 Act changed the quoted words to the simpler expression ''earnings or profits.'' The Commissioner first argues that the words ''earnings or profits'' in the 1924 Act should be interpreted as though no change had been made from the corresponding section of the 1921 Act, i.e., as though they read ''earnings or profits accumulated since February 28, 1913, or earnings or profits accumulated prior to March 1, 1913.'' The Commissioner then assumes that under the language of the 1921 Act Congress intended that the accumulated earnings or profits should be determined for each period *without regard to an impairment of capital.* Thus the basic assumption of the Commissioner's argument is the very question at issue. Certainly if Congress had intended that accumulated earnings or profits should be separately computed for the periods before and after 1913 and without regard to an impairment of capital it would not have changed the phrases used in the 1921 Act to the words ''earnings or profits.'' Nor would the Congressional Committee Reports quoted above (p. 6), in explaining this section of the 1924 Act, have stated that ''This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* * * * *constitute a return of capital.*'' Certainly the words ''earnings or profits'' in the Committee Reports cannot be interpreted as though they meant earnings or profits for two different periods separately computed.

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[3]The acts prior to the 1921 Act did not contain any section corresponding to section 201(c) of the 1921 Act.

There is therefore no merit to the Commissioner's attempt to answer our argument. Our point is simply that section 201(d) of the 1924 Act, in providing that if a distribution is not out of earnings or profits it must be applied to reduce the basis of the stock, coupled with the Committee Reports stating that such a distribution is a distribution of capital, makes it clear beyond any possibility of doubt that earnings or profits, or an earned surplus, are an essential prerequisite to the declaration of a taxable dividend. Further, we submit that Congress at no time intended otherwise, and that earnings or profits, or an earned surplus, always were an essential prerequisite to the declaration of a taxable dividend. If under the earlier statutes there was any doubt about this, that doubt was removed by section 201(d) of the 1924 Act.

Since at least under the Acts of 1924, 1926, 1928, 1932 and 1934 it is plain beyond question that earnings or profits, that is to say an earned surplus, are an essential prerequisite to the declaration of a taxable dividend, it follows that under those acts the statutory definition of a dividend must be interpreted so that a distribution made while a corporation has no earnings or profits, in other words, while its capital is impaired, does not come within the definition. Since the statutory definition of a dividend has remained unchanged (with the exception of an addition which the Commissioner does not contend has any bearing upon the problem) and since the identical words cannot possibly have changed their meaning, it follows that the critical words of the statutory definition

of a dividend must be interpreted for the years 1939 and 1940, here involved, in the same manner as under the Acts of 1924, 1926, 1928, 1932 and 1934. For these reasons, and for the further reason that the only answer which the Commissioner has been able to suggest is the obviously erroneous answer that earnings or profits are *not* an essential prerequisite to the declaration of a taxable dividend under the Acts of 1924, 1926, 1928, 1932 and 1934, we respectfully submit and contend that this Court erred in deciding that an impairment of capital existing on March 1, 1913 does not have to be restored before a corporation can have earnings or profits accumulated after February 28, 1913 available for dividends. The statutory definition must be interpreted to mean that there must first be earnings or profits, and secondly that the earnings or profits have been accumulated after February 28, 1913. This is so because a distribution which is not out of earnings or profits is not a dividend.

Wherefore, it is respectfully urged that this petition for a rehearing be granted.

Dated, San Francisco, California,
December 3, 1951.

Respectfully submitted,

Leon de Fremery,
Morrison, Hohfeld, Foerster,
Shuman & Clark,
Counsel for Respondents.

Certificate of Counsel.

I hereby certify that the foregoing petition for rehearing is in my judgment well founded and that said petition is presented in good faith and not interposed for delay.

Dated, San Francisco, California,
December 3, 1951.

Leon de Fremery,
Counsel for Respondents.